Economics and
Sociology
Occasional Paper
No. 1131

DEVELOPMENT STRATEGIES, CRISIS, AND DOMESTIC RESOURCE MOBILIZATION IN CENTRAL AMERICA

Claudio Gonzalez-Vega

Development Strategies, Crisis, and Domestic Resource Mobilization in Central America

Claudio Gonzalez-Vega

Introduction

This paper has been written as a background essay for the Conference on Financial Crisis, Foreign Assistance, and Domestic Resource Mobilization in the Caribbean Basin, to be held at The Ohio State University.1/ Central America is going through the most critical period of its recent history. Geopolitical, social, and economic problems in the region far surpass the difficulties experienced in the 1930s, during the Great Depression, and the consequences of the present crisis will reach beyond the sphere of economic events, shaping the institutional framework and the political and social fabric of the countries in the area. The region's destiny will be molded during the next few years, and the ways in which the present political and economic problems will be solved will determine the type of society and the level of welfare to be experienced by Central Americans during the rest of the century.

Although most of the world's attention has concentrated on the political dimensions of the Central American crisis, concern for the region's economic difficulties has not been missing. Numerous policies and programs have been proposed to deal with these issues.2/ In particular, the preliminary ideas contained in the Caribbean Basin Initiative have been expanded by the Report of the National Bipartisan Commission on Central America (the Kissinger Report). This Commission has urged "the immediate adoption of an emergency stabilization program combining public and private efforts to halt the deterioration," as well as a medium- and long-term reconstruction program.[3] The most important component of these recommendations has been a substantial increase in U.S. bilateral financial assistance to the region.

The disbursing of large amounts of financial aid, however, may be a far more complex and difficult exercise than the Kissinger Commission would imply.[4] Although the Commission recognizes that "large-scale economic aid alone does not guarantee progress,"[5] and that "the effectiveness of increased economic assistance will depend on the economic policies of the Central American countries themselves,"[6] the Report is very unsatisfactory when facing these problems and offering solutions. If experience in other countries teaches us anything, increased availability of foreign financial assistance tends to undermine the policy reforms that are necessary to face the crisis. Indeed, the "coffee boom" episode and the accompanying expansion of the external debt of the Central American countries suggest that large, temporary inflows of funds may not be sufficient to promote development and stability. To understand why this may be the case, one needs to examine the causes of the present economic difficulties. Although this has been done at length elsewhere, this paper attempts to summarize the main determinants of economic crisis in Central America.[7/]

In its analysis of the current economic conditions and their causes, the Kissinger Commission indicates that "adverse international and financial developments, natural disasters, ineffective economic policies within Central America, structural economic weaknesses, and high levels of violence have combined to produce inflation, a decline in economic activity, capital flight, and problems in servicing debt."[8/] Although this list includes several important determinants of the crisis, the intense effort required to understand the complex and interdependent issues examined by the Commission may explain their superficial approach to the economic problems of the region. Particularly striking is the lack of emphasis on the choice of development strategy as one of the structural determinants of the crisis. Also missing from the Report are a discussion of the role of the domestic financial system in mobilizing resources for development, as well as an analysis of the potential impact of large inflows of foreign financial assistance on the performance of domestic financial markets. The main objective of the present paper is to explore the role of the financial sector in mobilizing domestic resources, to evaluate the past performance of the Central American financial markets, to examine the importance of financial and related economic policies in shaping that performance, and to consider the probable impact that largely increased foreign financial assistance may have on the performance of domestic financial markets and on the policies that regulate them.

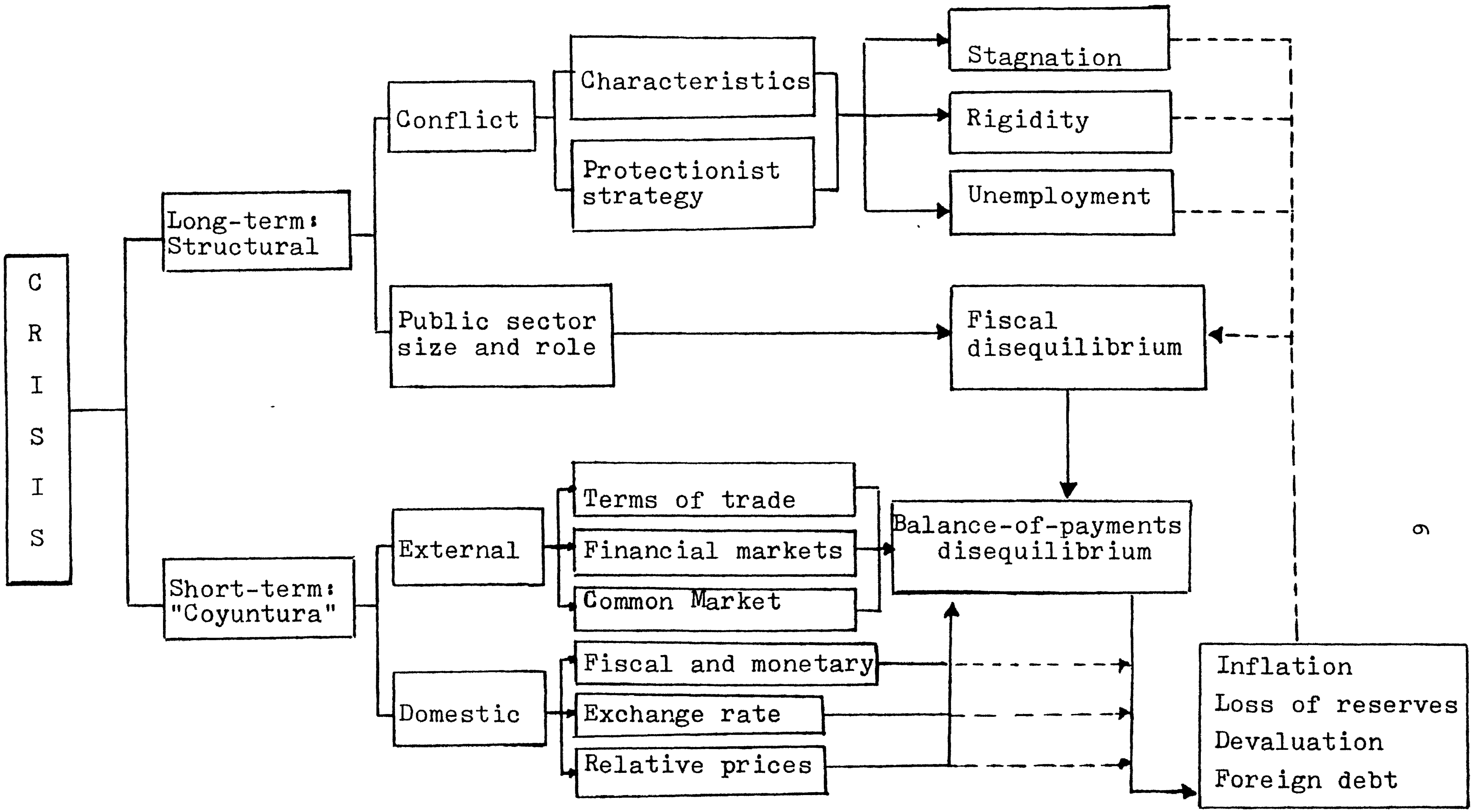
A first section reviews the causes of the present economic crisis in an stilyzed fashion. Both long-term, structural determinants, and short-term influences are taken into account. The importance of financial deepening in economic development is briefly explored next, through an enumeration of the services provided by an efficient financial system. Another section examines the process of financial deepening in Central America during the 1960s and the 1970s. It shows that lack of inflation and exchange-rate stability resulted in substantial financial deepening, despite lack of explicit concern with the mobilization of domestic savings. The following section investigates the impact that the crisis has had on the real size and performance of the domestic financial system. Finally, the paper speculates about the potential impact of increased flows of foreign financial assistance on policy reform, postponement of the adjustment, domestic resource mobilization, and financial deepening in Central America.

Development strategies, external shocks, and crisis

During the 1980s, the Central American countries have been in the midst of an acute economic crisis, characterized by stagnant or contracting outputs, by a rapid decline of their exports and imports, by growing unemployment, by large public-sector deficits and public external debts, by rapid inflation and the explicit or implicit devaluation of their currencies. These difficulties have been in sharp contrast with a record of rapid economic growth during the previous two decades, particularly during the second half of the 1970s.[9/]

These problems have reflected, in part, the instability and recession conditioning most of the Latin American countries in the early 1980s. Their magnitude and peculiarities have responded, however, to some of the most basic characteristics of the Central American economies. In effect, the crisis has resulted from a combination of long-term, structural trends, and of very unfavorable short-term circumstances (coyuntura) both abroad and at home. (See Chart).

The long-term determinants of the crisis have reflected a contradiction between some of the region's most basic economic characteristics and some of the main features of the protectionist strategy of development adopted in the late 1950s. The structural determinants of the crisis have also been associated with the increasing size of the public sector and the changing role of the state in the economy. These long-term circumstances explain much of the stagnation and rigidity of these economies, the growing unemployment and underemployment, and the accelerating inflation that has resulted from expanding fiscal imbalances. The short-term circumstances, on the other hand, have included both sizable


C R I S I S
Long-term: Structural
Short-term: "Coyuntura"
Conflict
Public sector size and role
Characteristics
Protectionist strategy
Stagnation
Rigidity
Unemployment
Fiscal disequilibrium
External
Domestic
Terms of trade
Financial markets
Common Market
Fiscal and monetary
Exchange rate
Relative prices
Balance-of-payments disequilibrium
Inflation
Loss of reserves
Devaluation
Foreign debt

external shocks as well as inappropriate policy decisions in response to these shocks.[10/]

The main economic characteristic of the Central American countries is their small size, with all the limitations imposed by a poor domestic market. By itself, each one of the Central American countries constitutes a miniscule and nonviable economy. Even the whole of Central America, with a population of about 22 million inhabitants and a gross domestic product (GDP) of about U.S. $20 billion, is a very small market. It is equivalent to any American city of about two million inhabitants. No city of this size ever dreams of being economically self-sufficient.

Given a small domestic market and a narrow resource base, these economies have been extremely dependent on international trade for an efficient allocation of resources and as an engine of growth. During this century much of the impulse for growth has been provided by exports of coffee, bananas, sugar, beef, cotton, and a few other primary commodities. Small size has inevitably resulted in very open economies, extremely vulnerable to the impact of external shocks.

With the adoption of a strategy of industrialization via import substitution, consolidated by the formation of the Central American Common Market, these countries hoped to reduce their external dependence and to achieve some degree of self-sufficiency. Although their strategy inplied free trade among themselves, in an effort to overcome the small size of their individual markets, they also erected a common, highly protective tariff barrier against imports from other countries. That is, while increasing their openness with respect to one another, they hoped to reduce it with respect to the rest of the world, as the regional market looked more dynamic, stable, and predictable than the international market.

Obviously, this is no longer the case. Furthermore, Central America has never been a large market, but market size is crucial for successful industrialization. In the early stages of import substitution, growth was made possible by the replacement of previously imported commodities with domestic production for the captive market. This stage was eventually completed, as easy opportunities for import substitution were exhausted by the mid-1970s. High protection, in turn, made it impossible for the manufacturing sector to compete in international markets.[11]

In summary, the contradiction between small market size and a strategy of development that emphasized production of manufactures for the domestic market eventually restricted growth potential, while high costs resulted from the distortions introduced and the accompanying penalization of agriculture and of exports.

Moreover, the strategy did not reduce dependence on imports. The common tariff structure favored the production of final consumer goods at the expense of intermediate inputs and of raw materials, resulting in a highly import-intensive manufacturing sector. As a consequence, the Central American economies have become increasingly dependent on their imports of raw materials, intermediate inputs, and capital goods. To acquire them, they have continued to rely on their traditional exports of primary commodities.

Further, the protectionist strategy did not reduce the region's dependence; it only changed its nature. Previously, dependence was associated with consumption patterns; now, it is associated with productive structures. These economies not only have become more vulnerable to external shocks, but also have lost their flexibility to adjust to these inevitable shocks. Balance-of-payments adjustment now involves a contraction of imports of raw materials and thus a corresponding reduction of production and employment in the manufacturing sector. These consequences, in turn, have resulted in efforts to postpone the adjustment, usually through increased borrowing abroad. This postponement has greatly increased the social costs of the adjustment.[12/]

Because they are very small and very open, the Central American economies are extremely vulnerable to the impact of external shocks. After 1973, they experienced a sequence of unusually large shocks, which included the two international oil crises, a sharp increase and later decline of the international prices of their export commodities (the "coffee boom"), followed by the world recession, and equally sharp changes in the terms and conditions of their access to international financial markets. War, insurrection, and political instability have reinforced the unfavorable shocks, further reducing the viability of the Central American Common Market and leading to capital flight and a contraction of domestic investment.[13/]

An important component of the recently increased economic instability of Central America has been a large swing in its international terms-of-trade. These terms-of-trade deteriorated sharply around 1974, as a consequence of the first oil crisis. However, they improved dramatically during the "coffee boom" (1976-77), to rapidly deteriorate again afterwards. This has been a very violent fluctuation in a short period of time. As a result, real incomes have also suffered a tremendous fluctuation, which has created a difficult problem of adjustment.

The rapid expansion of export earnings associated with the "coffee boom" significantly increased aggregate spending: consumption augmented, government expenditure even more, and imports even more. Further, aggregate expenditure increased not only as a result of the extraordinary export earnings, but was also fueled by rapidly growing borrowing in international financial markets. Soon, spending reached levels that could not be sustained under normal circumstances, much less during the recession that followed. Unfortunately, during these years the Central American governments made little effort to modify tax structures or to mobilize domestic savings through financial markets more effectively. As a consequence, the relative size of the public sector augmented, although not on the basis of increased tax revenues, but on the basis of external borrowing. The openness of the economy increased rapidly, as well, as long as international monetary reserves and access to international credit lasted.[14/]

By the turn of the decade, once these societies had become addicted to unsustainably high levels of aggregate spending, the demand for their exports declined, their international terms-of-trade deteriorated, and political instability further contributed to a sharp contraction of private capital inflows. Real income and import capacity were curtailed. The introduction of import controls could not release this constraint, but it further aggravated pessimistic expectations. The time had arrived for aggregate spending to grow more slowly, but such an adjustment faced much opposition. On the one hand, the manufacturing sector was extrenely dependent on imported inputs, while political constraints limited the magnitude of potential cuts in public (e.g., military and welfare) spending. To avoid the stagnation of manufacturing, the protected sector, and the contraction of the public sector, where unions have been most powerful, the authorities borrowed heavily abroad.

When foreign lenders decided that they did not want to finance the public-sector deficits of the Central American countries any longer, the authorities relied on financial repression and printed money as a tool to further postpone facing up to the consequences of the fall in income. These policies have led to a rapid loss of international monetary reserves, accelerating inflation, and the eventual devaluation of domestic currencies.[15] In the end, real consumption and other forms of spending have declined, after all, but a heavy cost has been paid in terms of rampant inflation, capital flight, and a worsening distribution of wealth, that might have been avoided, at least in part, by policies to facilitate the adjustment. In particular, the burden of the foreign debt acquired to postpone the adjustment will severely limit future opportunities for growth.[16]

In summary, as a consequence of structural trends and of unfavorable external shocks, the Central American economies have been experiencing a severe recession in economic activity. A serious drop in export earnings and the service of a large foreign debt have drastically reduced the flow of imports needed for production. Some of the factors contributing to these conditions have been beyond their control, but others have reflected the way in which the authorities have reacted to these events. The accumulation of too large a foreign debt, for example, has been mostly the result of attempts to postpone some of the unfavorable consequences of recent events. The situation has been difficult to manage because the unfavorable short-term shocks have been superimposed on a long-term trend of declining dynamism and productivity. To deal with these structural questions, however, requires important policy reforms.

The importance of financial deepening

Until recently, the role of the financial system and the nature of its contributions to economic growth in the less developed countries (LDCs) had received little attention. Although Schumpeter had recognized the role of finance in the unlocking of resources for innovation, investment, and growth, more recent theories of development had ignored financial activities or, at best, had treated them as passively adaptive.[17/] Several important theoretical developments anticipated a renewed interest in these questions. One was the formulation of monetary theory as a part of the theory of capital, which treated money as an asset alternative to other financial and tangible assets in wealth portfolios.[18/] Another one was the integration of monetary theory with the theory of economic growth.[19/] A third contribution was the analysis of the connections between financial development, the savings-investment process and real growth, pioneered by Gurley and Shaw.[20/] Despite these developments, the role of the financial system was excluded from the main traditions of theory and of practice with respect to the LDCs, until Shaw and McKinnon accorded money and the operations of the banking system a much greater degree of importance than had been previously recognized.[21]

Shaw insisted in looking at the financial system as just another productive sector, with its industries, markets, prices, institutions, and policies. In this sector, firms combine inputs, primarily human, according to relevant technologies, in order to produce a complex set of financial services, which Shaw saw mostly as intermediate inputs into another production processes. Financial services are not costless; supplying them is expensive in resources and their provision would be justified only to the extent that they increased aggregate productivity sufficiently to compensate for their opportunity cost.

The financial system provides several types of services.[22] First, its most basic service is the provision of a universally accepted medium of exchange. This is the traditional role of money. In its absence, high costs are associated with transactions, market size and trade are restricted, opportunities for specialization and division of labor are limited, and the productivity of resources is low. Thus, the costs of barter include not only the value of the resources spent in searching for trade partners, but also the losses of efficiency due to restrictions on market size.

Second, the financial system provides services of intermediation between surplus (saving) and deficit (investment) units, thus enhancing the accumulation of capital and improving its allocation.[23/] In the absence of finance, economic agents can take advantage of their productive opportunities only to the extent allowed by their own endowment of resources, while in other cases are forced to invest their excess resources poorly. There is no reason to expect that those units where savings are generated are necessarily those with the best investment opportunities and highest growth potential. By making the division of labor between savers and investors possible, the financial system can channel resources to those activities where they can be most profitably employed.

Through these intermediation services the financial system could contribute to the elimination of inferior uses of resources (that is, it could destroy uses with low marginal rates of return), while at the same time making possible better alternative uses. This is accomplished to the extent to which the financial system offers wealthholders new assets (e.g., bank deposits) that are more attractive forms of holding wealth than the unprofitable alternatives thus eliminated. In turn, the intermediary would transfer claims on resources towards those with better productive opportunities, which would otherwise remain unexploited. From this perspective, the financial system offers valuable services not only to borrowers, but also to depositors, while improving the allocation of resources.

Market fragmentation, the small size of transactions, high costs of information, and the uncertainties and risks characteristic of poor economies much increase the transaction costs observed in the financial markets of LDCs.[24/] As a result, the returns to savers are low, the total costs of funds to borrowers are high, the size of financial markets is small, and the volume of funds channeled and the variety of financial services provided are limited. Fragmentation and high and differential transactions costs also imply large dispersions of the marginal rates of return in the economy, which signal ample unexploited opportunities for improved resource allocation. Financial progress results from the reduction of these transactions costs and risks and improves the quality of the existing stock of capital through a reduction of the dispersion in marginal rates of return.[25/]

Transactions costs can be reduced by economies of scale and of scope, professional portfolio management, risk-reducing diversification opportunities, the accumulation of information, and the development of bank "customer" relationships. They cannot be reduced by decree (i.e., usury laws). Rather, interest-rate restrictions usually increase the total level of transactions costs imposed on actual and potential market participants and modify their incidence on borrowers, lenders, and depositors.[26/]

Third, the financial system provides reserve management services. Most economic units accumulate stores of value for emergencies or to take advantage of future investment opportunities. The financial system reduces the costs and risks associated with these precautionary and speculative reserves and, through the provision of "unused lines of credit," it reduces the size of the desired stocks of reserves, thus releasing resources for productive purposes.

Fourth, the financial system provides services of fiscal support for the public sector. This is an important contribution, in view of the weakness of tax structures and of securities markets in LDCs. The financial system also contributes to the management of foreign exchange.

In summary, economic development both depends on and contributes to the growth and diversification of the financial system. Financial deepening matters and financial services are important ingredients in the growth process, to the extent that they provide incentives for increased savings and investment, and encourage savers to hold a larger proportion of their wealth in the form of domestic financial assets, rather than unproductive inflation hedges and other money substitutes. The provision of credit is important, but deposit mobilization is important too.

The extent to which these services are provided depends on the real size of the financial system (the degree of financial deepening) and on the efficiency of its performance, as measured by the magnitude and dispersion of the transactions costs imposed on all market participants. The following sections explore the degree to which financial development in Central America has been successful in providing these crucial ingredients of economic growth.

Financial Deepening in Central America

In addition to being very small and very open economies, up to the mid-1970s the Central American countries were characterized by remarkable price stability. During the period of 1950 through 1969 the average annual rate of change of the Consumer Price Index (CPI) ranged from a high of 3.4 percent in the case of Nicaragua, to a low of 0.3 percent in the case of El Salvador, with rates of inflation in Costa Rica, Guatemala, and Honduras in the 1.0 to 2.0 percent range. None of these countries experienced double-digit inflation until 1973.[27/] Absence of inflation reflected the fact that these very open economies managed to keep their exchange rates fixed for long periods of time.[28/] Given such openness and constant exchange rates, their domestic price level was determined by the international price level, during a period when inflation in the

United States and other industrialized nations was minimal. The maintenance of a fixed exchange-rate regime reflected, on the other hand, a revealed preference of the Central American countries for monetary stability. That is, the stable rate was made possible by the strict monetary discipline that is required by a fixed-rate regime. An explicit objective of all Central Banks in the region, frequently emphasized, was the maintenance of "the external value" of the domestic currency. These Central Banks "knew" their monetary approach to balance-of-payments and exchange-rate stability well and had practiced its implicit prescriptions for a long time.[29]

In effect, during the 1950s and the 1960s, the rate of monetary expansion averaged less than 10 percent per annum in each one of the Central American countries, despite the fact that real incomes were growing rapidly and that, given the low levels of monetization of the early years, the demand for money was increasing at an even faster pace.[30] Between 1961 and 1971, the average (geometric) rate of increase of the money supply in a strict sense (M_1) was 8.0 percent per annum for the whole of Central America, and ranged between 5.4 percent in Guatemala and 12.0 percent in Costa Rica, the only country in the region that devalued during the 1960s.[31] During the same period, the average rate of increase of domestic credit was 11.0 percent per annum for Central America, ranging between 7.9 percent for

El Salvador and 17.3 percent for Honduras.[32/] Given moderate credit and monetary expansion, growing and open economies, and careful Central Banks, it is not surprising that inflation was alien to Central America until the mid-1970s.

Absence of inflation and exchange-rate stability made a significant degree of financial deepening possible in Central America, despite the lack of explicit concern with deposit mobilization, as is reflected in Table 1 and in the detailed data presented in the Statistical Appendix. By 1961, the financial system of the Central American countries was still comparatively small, as reflected by a ratio of the money supply (M_2), in the broad sense of currency, demand, savings, and time deposits, and a few other close money substitutes, with respect to the GDP, of only 15.3. This was a reflection of comparatively low per capita incomes, small size of domestic markets, and the existence of large segments of the population not fully incorporated to organized markets. By then, however, the ratio of the money supply in a strict sense (M_1), with respect to the GDP, had reached a level of 10.9, not much lower than those observed during the following two decades. That is, most of the "monetization" of the economy, and the provision of the first and most basic of the services of the financial system: the supply of a universal medium of exchange, had taken place during the 1950s and before, as relatively large

Table 1

Central America: Ratios of Selected Financial Magnitudes with Respect to the Gross Domestic Product, 1961-1981 (Percentages).

	1961	1966	1971	1976	1981
Currency	5.9	5.5	5.1	5.8	5.9
Demand deposits	5.0	5.8	6.4	7.6	6.3
Money supply (M_1)	10.9	11.3	11.5	13.4	12.2
Quasimoney (domestic)	4.0	7.4	10.6	14.6	13.8
Quasimoney (foreign)	0.4	0.2	0.3	1.0	1.4
Quasimoney	4.4	7.5	10.9	15.5	15.2
Money supply (M_2)	15.3	18.8	22.4	28.9	27.5
Money supply (M_2 domestic)	14.9	18.6	22.1	28.0	26.1
Domestic credit	19.6	23.9	27.2	32.8	41.3
Private credit	16.1	19.5	22.4	26.1	25.0
Public credit	3.5	4.4	4.8	6.6	16.4

Sources: Tables in the Statistical Appendix.

subsistence sectors had been progressively incorporated to the market economy of monetized transactions and banking habits had been acquired.

The largest portion of the impressive process of financial deepening observed during the 1960s and the 1970s, therefore, was associated with quasimoney (that is, non-monetary deposits). The ratio of quasimoney with respect to the GDP increased from 4.4 in 1961 to a maximum of 16.3 by 1978. As a result, the ratio of the money supply in a broad sense (M_2) with respect to the GDP reached 29.5 by 1979. The M_2/GDP ratios observed in the mid-1970s were comparatively high among LDCs, particularly with respect to those that had already experienced sustained inflationary pressures and more acute financial repression.[33/]

By 1961 there were already some differences in the degree of financial deepening observed among the Central American Countries. The M_2/GDP ratio was highest in El Salvador (19.7) and Costa Rica (18.0), intermediate in Guatemala (13.9), and lowest in Honduras (12.9) and Nicaragua (11.7), showing a loose correlation with per capita income. During the 1960s, the more rapid pace of financing deepening was experienced by Honduras. This country reached an M_2/GDP ratio of 24.7 by 1971, comparable to that of El Salvador (24.8) and higher than those of Guatemala (19.8) and Nicaragua (17.3). Costa Rica, which experienced the second fastest rate of financial deepening

Table 2

Central America: Ratios of Selected Components of the Money Supply, with Respect to the Money Supply Broadly Defined (M_2), 1961-1981 (Percentages).

	1961	1966	1971	1976	1981
Currency	38.4	29.3	22.9	19.9	21.5
Demand deposits	32.8	30.6	28.6	26.4	23.1
Money supply (M_1)	71.2	59.9	51.5	46.3	44.6
Quasimoney (domestic)	26.4	39.1	47.2	50.3	50.3
Quasimoney (foreign)	2.4	1.0	1.3	3.4	5.1
Quasimoney	28.8	40.1	48.5	53.7	55.4
Money supply (M_2 domestic)	97.6	99.0	98.7	96.6	95.0
Domestic credit	128.1	126.9	121.6	113.2	150.6
Private credit	105.3	103.7	100.2	90.3	90.9
Public credit	22.9	23.2	21.4	22.9	59.7

Sources: Tables in the Statistical Appendix during the 1960s, by 1971 still showed the highest ratio (27.7) among the five countries.

By 1978, Guatemala (24.5), El Salvador (30.7) and Honduras (31.6) had reached the maximum M_2/GDP ratios observed by each one during those two decades (1961-1981). Nicaragua reached a maximum (39.4) by 1979, and Costa Rica (41.2) by 1980. The lower degree of financial deepening experienced by Guatemala may have reflected the persistence of large subsistence sectors, while the recent increase of the M_2/GDP ratios in Nicaragua has been mostly a reflection of a rapidly contracting output. On the other hand, the very high ratios temporarily observed in Costa Rica during some of the most recent years have resulted from rapid expansion of domestic credit for the public sector, a question to be discussed later.

The Statistical Appendix provides abundant information on the components of the money supply in Central America. A few aspects of their evolution are worth mentioning here. Currency held by the public amounted to U.S. $166 million by 1961 and, as a proportion of GDP, remained fairly stable during the two decades. The currency/GDP ratio for the whole of Central America ranged between 4.9 (in 1975) and 6.5 (in 1979). In 1961 this ratio was lowest in Honduras (4.3) and highest in El Salvador (6.9), and during the 1960s showed a tendency to decline, except in Honduras. By 1971 it ranged between 3.9 (Nicaragua) and 6.3 (Costa Rica), and during the late 1970s increased rapidly in El Salvador and Nicaragua, both as a consequence of GDP contractions and, probably, of the impact of war, insurrection, and change of political system on the banking habits of the population.

In 1961, demand deposits in Central America amounted to U.S. $142 million, less than currency held by the public. The ratio of demand deposits with respect to the GDP then ranged between 3.8 (Honduras) and 7.3 (Costa Rica), and during the 1960s increased in all the countries, except Guatemala. A maximum of this ratio, of 7.9 for the whole of Central America, was reached in 1973, and then started to decline. That year (1973), this ratio ranged between 4.8 (Guatemala) and 13.1 (Costa Rica).

Between 1961 and 1971, currency held by the public increased 1.8 times, while demand deposits increased 2.6 times (in nominal terms). Between 1971 and 1981, however, while currency increased 4.0 times, demand deposits increased 3.5 times. As reflected in Table 2, the proportion of the money supply broadly defined represented by currency declined from 38.4 in 1961 to 18.7 in 1975, and slightly increased to 21.5 by 1981. On the other hand, the proportion represented by demand deposits remained fairly constant during the 1960s, but declined at an accelerating pace during the late 1970s. This suggests that, as inflationary pressures mounted, transactions balances were kept in new forms, different from checking accounts, for which the opportunity cost was high. In 1961, the ratio of demand deposits with respect to money, broadly defined, ranged between 29.3 (Honduras) and 40.9 (Nicaragua). Through the 1960s and early 1970s it was comparatively low in Guatemala, Honduras, and El Salvador, and high in Nicaragua and Costa Rica.

The M_1/GDP ratio ranged, in 1961, between 8.0 (Honduras) and 13.8 (Costa Rica). During the 1960s it declined in Guatemala (where it was 8.9 in 1971), was very stable in El Salvador and Nicaragua, and increased in Honduras and Costa Rica (where it was 17.9 in 1971). This ratio reached a maximum of 20.4 for Costa Rica in 1973. The M_1/M_2 ratio, on the other hand, steadily declined, from 71.2 in 1961, to 44.6 in 1981. This reflected the increased diversification of the money portfolios of the Central Americans, as different types of quasimoney were incorporated through time, in order to more closely satisfy their diverse tastes for return, risk, and liquidity. In 1961 the M_1/M_2 ratio ranged between 62.5 (Honduras) and 84.0 (Nicaragua), while by 1981 it ranged between 33.5 (Costa Rica) and 50.0 (El Salvador). The declining ratio observed in Costa Rica during the most recent years can be clearly associated with the inflationary process experienced in this country.

In 1961, the ratio of quasimoney with respect to the GDP ranged between 1.9 (Nicaragua) and 6.9 (El Salvador).

During the 1960s it increased rapidly in all the countries, to range between 7.8 (Nicaragua) and 13.2 (Honduras) by 1971. During the 1970s it increased most rapidly in Costa Rica, but slowly in the other countries. It ranged between 12.1 (Nicaragua) and 24.7 (Costa Rica) by 1981. On the other hand, the proportion of quasimoney with respect to money broadly defined (M_2) was low in Nicaragua (16.0) and high in Honduras (37.5) in 1961. By 1971 this proportion ranged between 35.5 (Costa Rica) and 55.1 (Guatemala), and by 1981 it ranged between 36.9 (Nicaragua) and 66.5 (Costa Rica).

U.S. dollar-denominated deposits with the domestic banking system have been included in the quasimoney figures, but they have been important only in Costa Rica, during the most recent years, as part of the process of currency substitution experienced by this country.[34/] For the whole of Central America, the relative importance of these deposits denominated in foreign currency increased from 1.3 percent of M_2 in 1971 to 5.7 in 1979. They have existed in every country except in Guatemala. In Costa Rica, however, their relative importance increased from 3.1 percent of M_2 in 1971, to 28.4 percent in 1981. In Honduras they reached a maximum relative importance of 5.8 percent in 1978, but this proportion has declined in recent years. By 1982, as a proportion of the GDP, these foreign-currency denominated deposits represented 9.8 percent in Costa Rica and 1.1 percent in Honduras (where they had represented 1.8 percent of GDP in 1978).

This increasing mobilization of financial resources through the domestic banking system has made possible a rapid expansion of domestic credit. Between 1961 and 1971, the ratio of domestic credit of the banking system with respect to the GDP, for the whole of Central America, increased from 19.6 to 27.2. In 1961 this ratio had ranged between 11.8 (Honduras) and 31.9 (Costa Rica), while in 1971 it ranged between 17.5 (Guatemala) and 36.6 (Costa Rica), after rapidly increasing in Honduras and Nicaragua.

Through the mid-1970s there had been a close parallel between increases in domestic resource mobilization and in domestic credit from the banking system, as shown in Table 2. During that period, domestic credit remained about 25 percent above domestic resource mobilization, while this difference was accounted for by the use of foreign funds in supplying domestic credit. In the late 1970s, the ratio of domestic credit to GDP increased in all of the countries, to range between 25.0 (Costa Rica) and 79.3 (Nicaragua) by 1981. The large increase in this ratio observed in Nicaragua and El Salvador has responded to sharp declines in output. These comparatively high levels of domestic credit, with respect to domestic resource mobilization, became possible through large increases in the use of foreign funds by the domestic banks. Thus, by 1981, domestic credit was

50 percent above domestic resource mobilization. At the same time, however, domestic credit for the private sector had declined, from 105 percent (1961) and 100 percent (1971) of domestic resource mobilization, to 90 percent by 1981, while domestic credit for the public sector, which absorbed 21 percent of domestic resource mobilization in 1971, was using 60 percent by 1981.

Despite this increased degree of financial deepening, as measured by aggregate ratios of financial magnitudes with respect to the GDP, the Central American economies have continued to rely heavily on foreign savings for the financing of their domestic investment. Although it has been shown that savings and monetary balances tend to be complementary in Central America (particularly in El Salvador, Honduras, and Costa Rica),[35/] domestic savings mobilization has remained comparatively low in Central America.[36/] Moreover, domestic financial markets have remained highly fragmented (and of a mostly urban character). Only a small proportion of the total population has had access to the new financial services offered. Also, the loan portfolios of formal financial institutions have shown much concentration: among those with access to loans, few have captured the largest proportion of the funds loaned. (In the case of agricultural loan portfolios, about 10 percent of the number of borrowers have received about 85 percent of the amounts outstanding).[37/] Moreover, high transactions costs have been imposed on all financial-market participants, so high that they have excluded large segments of the Central American population from participation in formal credit markets.[38/]

Financial-market fragmentation has reflected poor resources, limited education and sophistication, and the isolation of many economic agents. Uncertainty, the small size of transactions, and limited access to information have significantly increased the costs of participating in organized financial markets. Fragmentation has also resulted from government intervention, in the form of interest-rate regulations, reserve requirements, differential rediscounting mechanisms and loan-portfolio quota requirements, restrictions to entry, and other quantitative and qualitative regulations of financial activities. All of these problems, and the degree of financial repression, have been accentuated by the recent economic crisis. The following section explores the impact of the crisis on the real size and performance of the Central American financial systems.

Financial repression: the impact of the crisis

The Central American financial systems have suffered significantly with the crisis, probably more than most other sectors of economic activity. There has been a fiscal reason for this.[39/] When the stagnation and contraction of real incomes in the early 1980s reduced the rate of growth of government-revenue collection (which in some cases became negative, even in nominal terms), the Central American authorities faced substantial political and administrative constraints for an additional mobilization of domestic resources with the use of additional tools of conventional taxation. It became difficult to increase taxes in the face of economic recession, pessimistic expectations, and capital flight. Several tax reforms in Honduras, for example, did not bear any additional revenues. At the same time, given political instability and the government's short-run perspective, public-sector expenditures kept growing, increasingly above current revenues. The absence of any significant securities markets, on the other hand, precluded any substantial placement of government debt with private wealthholders.[40/]

Given this increasing discrepancy between public-sector revenues and expenditures, for a while the authorities financed their budget deficits by placing their debt abroad. This was very substantial in the case of Costa Rica and Nicaragua, but also significant for the other countries. When the limit to the stock of public external debt that foreign lenders were willing to accumulate was reached, and programmed expenditures had not been reduced yet, the Central American governments forced the placement of their debt with the domestic banking system.

The proportion of total domestic credit allocated to the public sector had remained fairly constant during the

1960s and early 1970s. For the whole of Central America, this proportion ranged between 16.7 percent (1968) and 20.1 percent (1972), prior to the first oil shock. In 1961 it ranged between 12.9 percent (Costa Rica) and 25.1 (Guatemala). By 1971 it ranged between 4.6 (Nicaragua, where it had declined sharply) and 27.4 percent (Guatemala). During the second half of the 1970s, however, this proportion increased rapidly, to reach 43.8 percent, for Central America, in 1982. During this last year, the proportion of domestic credit devoted to the public sector ranged between 33.7 (Honduras) and 50.6 percent (El Salvador).

As a proportion of the GDP, domestic credit for the public sector increased steadily, from 3.5 (1961) to 21.5 (1982). In 1961, this ratio ranged between 2.4 (Nicaragua) and 4.1 (Costa Rica), while in 1982 it ranged between 17.2 (Guatemala) and 31.3 (Nicaragua). By 1982 it represented 68.2 percent of domestic resource mobilization through the Central American financial systems.

The attempt to finance public-sector deficits by placing government debt with the domestic banking system has resulted, therefore, in two consequences. On the one hand, there has been an expansion of domestic credit at a rate faster than the rate that would maintain domestic price stability and the "external value" of the domestic currencies, thus breaking away with the old tradition of an exchange-rate target. On the other hand, there has been a drastic change in the shares of the private and the public sectors in total domestic credit, and the private sector has been "crowded out" from bank loan portfolios. Too rapid an expansion of domestic credit, in turn, has been reflected by excess demands for foreign exchange, for uses recorded both in the current and capital accounts of the balance of payments.

The Central American countries rapidly lost large stocks of international monetary reserves accumulated during the "coffee boom", further replenished by accelerating borrowing abroad. Large stocks of reserves and easy access to international financial markets meant that the exchange rate could be maintained fixed despite strong inflationary pressures generated by credit expansion. Ample availability of foreign-exchange reserves also facilitated the process of currency substitution and of capital flight that has taken place in some of the Central American countries. Eventually, as reserves were lost, import- and foreign-exchange controls were imposed. These controls, although ineffective from an aggregate perspective, are actually used to ration scarce foreign exchange among competing uses. The rationing process, however, imposes high transactions costs on demanders of foreign exchange, implicitly increasing its "price". Also, parallel markets for foreign exchange have formed in all the countries, while Costa Rica, in particular, has allowed the "interbank" exchange rate to float, in addition to a formal devaluation of its official exchange rate.[41/]

In summary, fiscal deficits have been financed with losses of international monetary reserves, additional foreign borrowing (and, recently, in the case of Costa Rica, with a moratorium on the payments of interest and principal on this debt), and finally with the inflation tax. In order to avoid this tax, Central Americans have replaced domestic financial assets with other assets (including foreign currency) and the immediate consequence of this "flight from domestic money" has been a reduction in the real size of domestic financial systems.

In real terms, the banking system of all the Central American countries has contracted during the past few years.[42/] This contraction has been least pronounced in Guatemala, where measured in constant quetzales-of-1975, the money supply in a broad sense (M_2) reached a maximum of 1,069 million by the end of 1978. In real terms, M_2 had grown at an average (geometric) rate of 9.7 percent per annum between 1970 and 1977, but it only grew at a rate of 0.3 percent per annum between 1977 and 1981. (It declined by 5.0 percent in 1979). Between 1970 and 1977, the money supply in a strict sense (M_1) grew at a rate of 8.0 percent per annum to reach its maximum value of 449 million of constant quetzales in 1977. It declined at a rate of -3.3 percent between 1977 and 1981, but recuperated in 1982.

Quasimoney, on the other hand, had grown at an average annual rate of 11.1 percent between 1970 and 1977, but grew only at a rate of 3.7 percent per annum between 1977 and 1981 (including a decline in 1979).

The contraction has been very dramatic in El Salvador, where political dimensions have been added to financial and economic circumstances. By 1977, the money supply in a broad sense (M_2) reached a maximum of 1,683 million of constant colones-of-1975, after growing at an average rate of 9.2 percent per annum between 1970 and 1977. It has been declining, however, at a rate of -5.6 percent between 1977 and 1982. The money supply in a strict sense (M_1) reached a maximum of 854 million of constant colones by 1976, after growing at an annual rate of 11.2 percent between 1970 and 1976. Between 1976 and 1982, however, it declined at a rate of -5.6 percent. Its level in 1982 was only 70.8 percent of its level in 1976. Quasimoney, on the other hand, grew at a rate of 9.7 percent per annum between 1970 and 1977, to reach a maximum of 870 million of constant colones. Between 1977 and 1982, however, it declined at a rate of -5.5 percent per annum. Its value during the latter year was 75.3 percent of its value during the former year.

In Honduras, by 1978 the money supply in a broad sense (M_2) reached a maximum of 924 million lempiras-of-1975. Between 1970 and 1978, M_2 grew at a rate of 10.1 percent per annum, but between 1978 and 1982 it declined at a rate of

Table 3

Central America: Annual Rates of Growth of Selected Financial Magnitudes, in Real Terms, 1978-1982 (Percentages).

	Guatemala	El Salvador	Honduras	Costa Rica
Money supply (M_2)				
1978	4.2	- 2.8	14.1	15.7
1979	- 5.0	- 5.5	- 8.6	11.1
1980	1.6	- 13.8	2.4	- 1.3
1981	2.8	- 0.5	- 3.7	9.9
1982	17.2	- 5.0	6.3	- 17.6
Quasimoney				
1978	7.6	- 1.7	11.7	19.3
1979	- 7.0	- 14.9	- 10.4	23.1
1980	7.5	- 20.0	- 0.6	0.1
1981	7.4	14.0	- 1.0	22.0
1982	25.4	- 1.3	14.8	- 19.3
Money supply (M_1)				
1978	- 0.2	- 4.0	17.0	11.8
1979	- 2.3	4.9	- 6.7	- 2.6
1980	- 6.2	- 8.2	5.7	- 3.2
1981	- 4.3	- 11.7	- 6.5	- 8.2
1982	3.4	- 8.7	- 3.1	- 14.4
Domestic Credit				
1978	7.1	- 1.4	12.4	18.1
1979	- 3.5	6.1	- 1.0	22.0
1980	21.2	8.1	5.3	7.0
1981	22.1	7.5	2.2	- 30.4
1982	29.1	- 1.7	2.4	- 22.4
Private Credit				
1978	17.3	0.8	8.6	14.8
1979	5.2	- 2.4	- 5.1	6.1
1980	12.2	- 26.2	0.4	- 3.9
1981	3.3	0.7	- 2.3	- 33.4
1982	9.2	- 1.0	- 0.3	- 24.1

Sources: Tables in the Statistical Appendix.

-1.1 percent per annum. Between 1970 and 1978, the money supply in a strict sense (M_1) grew at a rate of 8.7 percent per annum, to reach a maximun of 431 million of constant lempiras. Between 1978 and 1982, however, this magnitude declined at a rate of -2.8 percent. Quasimoney, on the other hand, grew at a rate of 10.8 percent between 1970 and 1978, but declined at a rate of -4.1 percent between 1978 and 1981, from a maximum of 493 million of constant lempiras in 1978.[43/]

The contraction has also been dramatic in Costa Rica.[44/] The money supply in a broad sense (M_2) reached a maximum of 10,994 million colones-of-1975 as late as 1981 and then declined. However, when deposits with the banking system denominated in U.S. dollars are excluded from M_2, this magnitude reached a maximum of 8,591 million of constant colones by 1980 and then declined. If dollar-denominated deposits are not excluded, between 1970 and 1978 real M_2 increased at a rate of 17.7 percent per annum, but the 1982 level was about the same as that reached by 1978. If dollar-denominated deposits are excluded, between 1970 and 1978 M_2 grew at a rate of 16.7 percent, to decline at a rate of -4.5 percent per annum between 1978 and 1982.

The contraction of the money supply in a strict sense (M_1) was very pronounced in Costa Rica. Between 1970 and 1978 M_1 had grown at an average rate of 11.3 percent, but it declined at a rate of -7.2 percent between 1978 and 1982. By

1982 its value was only 74.1 percent of its value by 1978. Between 1970 and 1979, quasimoney, including dollar-denominated deposits, grew at the incredible rate of 27.8 percent per annum, in real terms, but its 1982 level was similar to its 1979 level. When dollar-denominated deposits are excluded, however, between 1970 and 1979 quasimoney grew at a rate of 25.3 percent per annum but declined at a rate of -3.6 percent between 1979 and 1982.

The rapid expansion of domestic resource mobilization through the banking system that took place during most of the 1970s made a rapid expansion of domestic credit, in real terms, also possible. In Costa Rica, for example, between 1970 and 1978 domestic credit increased at an average rate of 13.4 percent per annum, and it continued increasing through 1980. During the last years of this period, this rate exceeded the rate of expansion of domestic resource mobilization due to increasing borrowing abroad by the banking system, and thus domestic credit reached a maximum of 13,670 million of constant colones of 1975, by the end of 1980. In real terms, nevertheless, domestic credit declined by 30.4 percent in 1981 and by 22.4 percent in 1982. As a consequence, at the end of 1982 the real value of domestic credit was only 54.0 percent of its real value in 1980. That is, the inflationary pressures generated by the expansion of domestic credit itself (in nominal terms) and the loss of the country's international monetary reserves eventually resulted in a sharp contraction of the real value of domestic credit. In the race between growth of domestic credit in nominal colones and inflation, the latter was an easy winner.

Between 1970 and 1978, in Cost Rica domestic credit for the private sector grew at an average rate of 11.5 percent per annum, but between 1978 and 1982 it declined at a rate of -16.5 percent per annum. At the end of 1982 the value of domestic credit for the private sector was only 48.6 percent of its value in 1978. On the other hand, domestic credit for the public sector grew at a rate of 24.1 percent per annum between 1970 and 1980, but then quickly declined, so that by 1982 it represented only 58.3 percent of the value reached in 1980. The lesson is clear: too rapid an expansion of domestic credit, in nominal terms, eventually resulted in a sharp reduction of this magnitude, in real terms. This was the case even with respec to domestic credit for the public sector, and despite the "crowding out" of the private sector from domestic credit portfolios.

Although domestic credit has not experienced the same dramatic reversal in the other Central American countries, its behavior tells a similar story (with some lags). In Honduras, between 1970 and 1978, domestic credit grew at a rate of 10.6 percent per annum, but this rate dropped to 2.2 percent per annum for 1978 to 1982. In El Salvador, between

1970 and 1977 domestic credit grew at a rate of 8.0 percent per annum, but it grew only at a rate of 3.6 percent per annum from 1977 to 1982. Only in Guatemala, where financial repression has been least, has domestic credit continued to grow rapidly. Between 1970 and 1977, domestic credit grew at a rate of 8.4 percent, while this rate increased to 14.6 percent for the 1977-1982 period.

The evolution of domestic credit allocated to the private system more clearly illustrates the consequences of increased financial repression. In Honduras, credit for the private sector increased at a rate of 9.8 percent per annum between 1970 and 1978 to reach a maximum of 971 million of constant lempiras by 1978. Between 1978 and 1982, it declined at a rate of -1.8 percent per annum. In El Salvador, between 1970 and 1978 credit for the private sector increased at a rate of 6.8 percent, to a maximum of 1,536 million of constant colones by 1978. It declined at a rate of -7.9 percent between 1978 and 1982. Its 1982 value was only 71.8 percent of its 1978 value. In Guatemala, on the contrary, while domestic credit for the private system increased at a rate of 6.6 percent per annum between 1970 and 1978, it grew at a rate of 7.4 percent per annum between 1978 and 1982.

As a result of the contraction in the real size of the banking system, the ratio of M_2 with respect to the GDP declined in all four countries. In Costa Rica, it declined from 41.2 in 1980 to 28.8 in 1981, reversing the increasing trend observed during the 1970s. Moreover, if dollar-denominated deposits are excluded from M_2, this ratio declined from 35.4 in 1980 to 20.6 in 1981. In Honduras it slightly declined from 32.1 in 1979 to 31.2 in 1980, and this rate, that had been growing very fast, stagnated during the most recent years. In El Salvador, the M_2/GDP ratio reached a maximum of 32.9 in 1976, to decline for the following four years, to 29.3 in 1980, but then increased, not because of financial deepening, but due to too rapid reductions in GDP. In Guatemala it also reached a maximum in 1976, of 25.2, and declined to 22.6 by 1980.

With this process of contraction of the financial system during the crisis, there have been important changes in the composition of credit portfolios. As indicated, the private sector has been "crowded out" from domestic credit portfolios in all the Central American countries, while the public sector has significantly enlarged its share.[45/] In Costa Rica, the share of the private sector had already declined from 87.1 percent (1961) to 79.4 percent (1975). This share, however, further contracted to 52.1 (1982). In Honduras, it had declined from 76.6 (1961) to 74.7 (1979), to further fall to 66.3 (1982). In El Salvador, it had declined from 85.1 (1961) to 83.3 (1978), to drastically fall to 49.4 (1982). In Guatemala, it had fallen from 74.8 (1961) to 69.7 (1978), to rapidly decline further to 50.4

(1982). Moreover, in all these countries, the contraction of the share of the commercial banks, as opposed to the share of the public sector, in Central Bank credit was even more pronounced than indicated by these figures.

It is important to keep in mind that, while this contraction of the real flows of domestic credit, particularly for the private sector, took place, the flows of external credit were also being curtailed, and that the crisis has seriously reduced the real value of the working capital (owned financial resources) of most firms, too. Other changes in the structure of the banking system resulted from this non-uniform contraction of its components. In some countries, (e.g. Honduras), development banks have maintained a privileged access to Central Bank rediscounting and to funds from international donors, which have limited the extent of the reduction in the real value of their loanable funds. At the same time, however, significant portions of the portfolios of these publicly-owned banks have become overdue and may never be collected. Thus, although the real value of the stock of outstanding credit balances has not declined (as defaulted loans have not been written off), the real value of the annual flows of new loans has fallen substantially.[46/] Commercial banks have also lost some of their share of the market for deposits to savings and loan associations and to *financieras*, which have been able to offer more attractive interest rates on deposits. In Costa

Rica, "private banks", which have been allowed to offer long-term deposits only, have gained at the expense of the nationalized commercial banks, which have enjoyed a monopoly in the mobilization of demand deposits. The increasing share of "private banks" in this market has been due to the rigidity and obsolescence of the nationalized banking system, used to operate without competition, to the aggresive behavior of the new "private banks", and to the support that these have received from international donors. (It is interesting to note that non-regulated and informal intermediaries have also experienced spectacular gains at the expense of the commercial banks in the Dominican Republic).[47/] In some countries, particularly in Costa Rica, dollar-denominated deposits have gained at the expense of deposits denominated in domestic currencies.[48/] The shares of various sectors of economic activity in domestic credit portfolios have also changed. The share of "productive" sectors, and particularly that of agriculture, have declined, at the expense of the share of real estate, commerce, and other "speculative" activities.[49/] The number of clients of banking institutions has diminished sharply in several of these countries.

Crisis and financial services

Between 1960 and the "coffee boom" of 1976-77, the Central American countries experienced a substantial degree of financial deepening, as reflected by the steady increase in the ratios of financial magnitudes with respect to the GDP, the establishment of a wider set of financial intermediaries, increased competition in financial markets, and the geographical expansion of the branch network.[50/] Financial growth was explained by the vigorous growth of output, in real terms, and by exchange-rate stability and the absence of inflation. The latter two factors, in turn, reflected cautious fiscal, credit, and monetary policies, aimed at maintaining exchange-rate and price stability. As a result, exchange-rate risks were minimal, and during most of this period interest rates were positive, in real terms, in all of the Central American countries.[51/]

The events of the late 1970s and early 1980s, however, led to a reversion of this favorable trend. By the turn of the decade, the real size of the banking systems was shrinking, loan portfolios were showing an increasing concentration in favor of a smaller number of larger borrowers, the numbers of bank clients were declining, and several financial institutions were experiencing severe default problems. All of this suggests that important changes were taking place with respect to the extent and relative degree with which the Central American banking systems were providing different types of financial services.

First, the opportunity cost of holding transaction balances in domestic currencies had increased. As a consequence, the ability of these banking systems to provide the services of a stable medium of exchange was reduced. Since evasion of the inflation tax is very easy in such open economies, the reduced comparative advantage of domestic currencies in supplying monetary services resulted in currency substitution.[52/] Although currency substitution allowed economic agents to maintain the real value of their money balances, despite domestic inflation, it also limited the ability of the domestic financial system to provide other services important for growth and development.

Second, because of the contraction, when measured in real terms, of both the domestic liabilities and the domestic assets of the banking system, less intermediation services between surplus (savings) and deficit (investment) units were provided. The degree of intermediation was reduced with the lower relative importance of domestic financial assets in wealth portfolios, and with the "crowding out" of the private sector from bank credit portfolios. With the crisis, however, more expanded intermediation services were required, given changes in relative prices and in other dimensions of the economic environment that made a flexible mechanism for resource reallocation necessary. Financial intermediation becomes more important during periods of economic adjustment. The Central American banking systems, however, were suffering from a reduced ability to provide these crucial services.

Third, given high inflation and devaluation expectations, domestic financial assets became poor stores of value for precautionary and speculative purposes. With the contraction of the financial system, in real terms, the value of "unused lines of credit" to potential borrowers was reduced. While the search for inflation hedges, a more limited access to formal credit, and increased risks and uncertainty may have contributed to a relatively larger demand for reserves, the Central American financial systems were in a less favorable position to supply these services. As Central Americans substituted foreign assets for their domestic financial assets (and, given the relative importance of transactions costs, domestic inflation hedges for domestic financial assets), inflationary pressures were exacerbated, further repressing the domestic financial systems.

The recent Central American experience has been clearly characterized by an excessive emphasis on the fiscal-support functions of the domestic financial system. Emphasis on financing public-sector activities has led to a rapid expansion of domestic credit, in nominal terms, and the acceleration of inflation. As reported in the previous sections, in the race between growth of credit in nominal terms and inflation, eventually inflation has been the winner. Emphasis on financing public-sector activities has also resulted in the "crowding out" of the private sector from bank credit portfolios. In conclusion, the domestic financial system of the Central American countries has become much less of an intermediary between private savers and investors, and much more of a fiscal instrument, to tax resources away from wealthholders in order to finance current public expenditures and, more recently, the service of an excessive public external debt. This lack of balance in the provision of financial services and abuse of its fiscal function has significantly jeopardized the ability of the domestic financial system to promote economic development and financial stability. The crisis, with its postponement of the required adjustment of aggregate spending, its increasing foreign debt, and accelerating inflation and devaluation has increased financial repression in Central America.

Foreign assistance, policy reforms, and resource mobilization

When the Central American countries designed their protectionist strategies of development in the late 1950s and embarked upon the creation of the Central American Common Market, all the emphasis was placed on trade policies, industrialization, and structural transformation. With the assistance and encouragement of the United Nations Economic Commission for Latin America (ECLA), firt, and of the United States, later, the Central American Common Market provided for free trade within the region and the harmonization of tariff rates to a common external tariff schedule.[53/] Attention concentrated on the current account of the balance of payments and on the potential growth and employment effects of the protectionist policies.

At that time, growth models did not include a role for domestic resource mobilization through the financial system. The marriage of neoclassical growth models with Keynesian macroeconomics overemphasized aggregation. Given an exogenous rate of population growth and an aggregate production function, output was viewed as a function of capital and growth was viewed as a function of investment. Capital accumulation, in turn, was seen as the result of both domestic and foreign savings. An structuralist view of the world resulted in the belief that the supply of savings was insufficient and completely inelastic. The problem of growth, therefore, became one of filling the two gaps: the difference between domestic savings and investment, given a desired rate of growth, and the difference between foreign exchange requirements and export earnings plus capital inflows.[54/] Foreign financial assistance was viewed as the means of obtaining the additional foreign exchange required to maintain a high rate of growth, close the gap between the demand for imports thus generated and the region's regular export earnings, and complement domestic savings.[55/] No active role was assigned to the domestic financial system.

To the extent that savings were considered interest-rate-inelastic, there was no scope for financial deposit mobilization. To the extent that there was a tendency to assume that all investment is good and to ignore that some investments yield much and others little, and still others bear negative yields, there was no appreciation of the allocative role of financial intermediation.[56/] Armed with Harrod/Domar equations, linear programming, and crude input-output tables, planners targeted sectoral and subsectoral investment totals even when there were no projects, no levers to influence their creation, and no analysis to show that those would be good uses of scarce resources. Although problems of managing the economy in the short run, handling fluctuations and shocks, were neglected, cautious fiscal and monetary policies, coupled with international stability, facilitated investment and financial deepening.

The Alliance for Progress Program was inspired in the 1960s by this simplistic view of the world. Growth and development were to be achieved through inflows of foreign financial assistance. In the process of aggregation, individual production, consumption, investment, saving, and portfolio choices were ignored. Relative prices, elasticities, and incentives were not taken into account. The impact of the institutional framework, political climate, size and role of the public sector and economic policy management on the profitability of investment, expectations, and resource allocation were not considered. Rather, the emphasis was on obstacles, bottlenecks, and constraints. If domestic savings were not sufficient, foreign financial assistance would complement them. If private investors did not find productive activities attractive, the public sector would borrow abroad and directly invest in productive enterprises. Unfortunately, in its economic analysis, the Kissinger Report has not gone much beyond this perspective.[57/]

As indicated, the present economic crisis has resulted from both long-term, structural circumstances, and short-term factors. The Kissinger Report stresses the latter. It would be a great mistake to believe that stagnation, low profitability, fiscal imbalance, and rigidity have a recent origen. Little consideration, if at all, is given in the Report to the choice of development strategy.[58/] Although the Report calls for "efforts to reinvigorate the Central American Economic Market" and claims that "support to the Common Market would be one of the quickest ways to revive intra-regional trade and economic activity," no evaluation of the protectionist policies and of required policy reforms is offered. As a necessary condition for the recovery, a substantial increase in aid is recommended.[59/]

The present economic situation in Central America requires important policy revisions, in order to regain the growth dynamics of the past and restablish financial stability. Most of these reforms are overdue. The required policy package must be directed towards promoting investment, increasing competitiveness in international markets and improving export performance, mobilizing a larger proportion of domestic savings, and channeling those savings more efficiently, through the financial system, towards more socially profitable activities, as well as regaining control of the public-sector finances, in order to avoid inflation and "crowding out."

In some of the Central American countries these policy reforms must include a revision of exchange-rate policies. The futility of tariff and non-tariff barriers to trade as a mechanism for balance-of-payments or exchange-rate stability has to be understood. Lower and uniform tariffs, combined with realistic exchange rates, would encourage exports. Financial policies to promote the mobilization of voluntary deposits and increased competition in credit markets are also required. The policy reforms may also include a reduction in the size of the public sector, particularly in the area of productive enterprises, as well as a reduction of the multitude of explicit and implicit subsidies.

There has been a long controversy about the extent and ways in which foreign financial assistance contributes to economic growth in the LDCs.[60/] Within the North-South debate, LDCs have claimed that a massive inflow of resources from the North is needed to accelerate growth and to reduce poverty in the South. Others, however, have emphasized the importance of self-help, well-functioning markets, and non-distorting policies. A few have even claimed that the absence of foreign aid is almost a prerequisite for economic progress in the LDCs.[61/] The Kissinger Report emphasis the role of foreign financial assistance.

The justification for increased aid is based on the presumption of a positive relationship between the volume of capital inflows and the rate of economic growth. This, in turn, is based on the assumption that foreign funds will add to domestic savings, in order to increase total investment, and that efficiency will not benegatively affected by the inflow of foreign resources. Given the fungibility of funds, however, foreign resources may substitute for domestic savings, increasing consumption or capital flight.[62/] The net additionality of foreign aid with respect to domestic investment will always be less than the actual amount of the financial inflow. Aid may also reduce the efficiency in the allocation of resources. To the extent to which aid allows an overvaluation of the domestic currency, it discourages exports.[63/] Also, foreign financial assistance has frequently contributed to the unproductive investments and interventionist policies of many governments. As a leading Guatemalan recently claimed, "the combination of have-money-must-lend international institutions and spendthrift politicians has been one of the main causes of the sad state of economic affairs in Latin America."[64/]

Development depends on an improved allocation of all resources, domestic and foreign. Domestic economic policies (trade and price policies, incentives, taxes, and the size of the public sector, and financial deepening) crucially determine the "effectiveness" of domestic and foreign resources. Too frequently, however, the availability of external financial assistance has made the maintainance of growth-reducing policies possible. Large amounts of financial assistance may take away the incentives to mobilize domestic resources. Large amounts of assistance may take away the incentive for governments to create more efficient and equitable tax administrations and to promote the mobilization of voluntary domestic savings through local financial institutions. With large amounts of financial assistance, the Central American governments will be able to sustain the existing structures of protection that favor inefficient industries, tax the rural areas, and penalize exports.

Too much foreign financial assistance may neutralize some of the healthy consequences of the crisis and allow governments to resist demands for policy reforms. By bailing the Central American governments out, it would make it possible for them not to undertake the desired reforms. Foreign assistance may also make it possible for these governments to continue entering productive sectors and sustaining large bureaucracies. So far, the public external debt has been the mechanism to postpone adjustment and reforms. There is a great danger that foreign financial assistance may have exactly the same result. If a few years down the line, when political support for the increased flows of aid disappears, external assistance suddenly comes to a halt, these countries may find out that they have built up their expenditures a lot, but have not mobilized their own resources to pay for the bill.

In the past, exceptional inflows of funds (during the "coffee boom," with the accelerating borrowing abroad, etc.) have always come to an end. When the period of substantial financial assistance is over, if the policy reforms are not made, the Central American economies will be weaker, more distorted, more unstable, perhaps even worse off. Policy reforms and emphasis on voluntary mobilization of domestic savings, on the other hand, are a prerequisite for the success of moderate levels of foreign financial assistance.

Notes

1. The Conference on Financial Crisis, Foreign Assistance, and Domestic Resource Mobilization in the Caribbean Basin is being sponsored by the Agricultural Finance Program, at The Ohio State University, and the Interamerican Institute of Capital Markets (Caracas, Venezuela). It will be held at the Fawcett Center for Tomorrow, in Columbus, Ohio, on April 30 and May 1, 1984. Assistance in handling the data for this paper was provided by Arnoldo R. Camacho.

2. Comision Economica para America Latina, "La Crisis en Centroamerica: Origenes, Alcances y Consecuencias," E/CEPAL/MEX/83/R.3/Rev.1, May 27, 1983. Eduardo Lizano, "El Mercado Comun Centroamericano en una Epoca de Turbulencia," El Trimestre Economico 50, No. 3:1475-1506 (September, 1983).

3. Report of the National Bipartisan Commission on Central America (January, 1984), p. 47.

4. See Douglas H. Graham, "Central America: What's the Answer?" The Columbus Dispatch, January 29, 1984.

5. Report of the National Bipartisan Commission on Central America, cit. p. 41.

6. Ibid., p. 53.

7. Several studies have concentrated on the economic crisis in Costa Rica, which has been the most acute. For a review of some of them see Marc Edelman, "Recent Literature on Costa Rica's Economic Crisis," Latin American Research Review 18, No. 2:166-180. See also, Victor Hugo Cespedes, Claudio Gonzalez-Vega, et al., Costa Rica: Una Economia en Crisis, San Jose: Editorial Studium, 1983.

8. Report of the National Bipartisan Commission on Central America, cit., p. 41.

9. The main characteristics of the crisis have been explored by several international agencies. See Comision Economica para America Latina, "Evolucion de la Integracion Centroamericana en 1981," (E/CEPAL/MEX/1982/L.17), May, 1982.

10. This distinction has been used in a detailed analysis of the crisis in Costa Rica in Victor Hugo Cespedes, Claudio Gonzalez-Vega, et al., Problemas Economicos en la Decada de los 80, San Jose: Editorial Studium, 1983, and in Victor Hugo Cespedes, Claudio Gonzalez-Vega et al., Costa Rica: Una Economia en Crisis, cit.

11. For a discussion of these issues, see Bela Balassa, The Newly Industrializing Countries in the World Economy, New York: Pergamon Press, 1981, particularly Essay 1: "The Process of Industrial Development and Alternative Development Strategies."

12. For an analysis of the consequences of the postponement of the adjustment in the case of Costa Rica, see Claudio Gonzalez-Vega, "Fear of Adjusting: The Social Costs of Economic Policies in Costa Rica in the 1970s," in Donald Schulz and Douglas H. Graham, eds., Revolution and Counter-Revolution in Central America and the Caribbean, Boulder: Westview Press, 1984.

13. Political instability in Central America has attracted much world attention. Insurrection and political instability, however, have not been the major cause of the region's economic problems. Political instability, of course, is both a cause and a consequence of economic instability, but economic difficulties would have characterized the recent history of Central America even in the absence of turmoil. These difficulties have been a consequence of the magnitude, in a short period, of the oscillations in macroeconomic aggregates as a result of the external shocks, and of the rigidity of productive structures resulting from the choice of development strategy, as well as of inappropriate policy responses to these shocks.

14. The relative importance of exports changed little, but the relative importance of imports and, as a consequence, of the trade deficit increased. In the case of Costa Rica, however, as the country has been forced to face the service of its external debt, openness has declined sharply.

15. There have been, of course, important differences among the Central American countries. In some of them (Nicaragua, El Salvador), war and political unrest have been a major factor. In others (Honduras, Costa Rica), the role of economic policies can be more clearly isolated. This has been particularly true in the case of Costa Rica, where the crisis reached unpredictable heights.

16. See Guillermo Ortiz, "A Note on the Burden of the Mexican Debt," paper presented at the Conference on the Economic Problems of the Caribbean Basin, Santo Domingo, December 1983.

17. See Joseph A. Schumpeter, The Theory of Economic Development. An Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle, London: Oxford University Press, 1934, 1969. The financial sector was

missing, or at best assigned a minor role, in Harrod-Domar and neoclassical growth models, Lewis-Fei-Ranis labor-surplus models, Leontief fixed-coefficient models, and Chenery two-gap models. As Joan Robinson claimed, it was believed that "where enterprise leads, finance follows." See Joan Robinson, Collected Economic Papers, Oxford: Basil Blackwell, 1960.

18. Milton Friedman, ed., Studies in the Quantity Theory of Money, Chicago: The University of Chicago Press, 1956. James Tobin, "Liquidity Preference as Behavior Towards Risk," The Review of Economic Studies 25, No. 2:65-86 (February, 1958).

19. David Levhari and Don Patinkin, "The Role of Money in a Simple Growth Model," The American Economic Review 58, No. 3:713-753 (September, 1968).

20. John G. Gurley and Edward S. Shaw, "Financial Aspects of Economic Development," The American Economic Review 45, No. 4:515-538 (September, 1955) and John G. Gurley and Edward S. Shaw, "Financial Structure and Economic Development," Economic Development and Cultural Change 15, No. 3:257-268 (April, 1967). Other early studies of finance and development were Raymond W. Goldsmith, Financial Structure and Development, New Haven: Yale University Press, 1969, and Hugh T. Patrick, "Financial Development and Economic Growth in Underdeveloped Countries," Economic Development and Cultural Change 14, No. 2:174-177 (January, 1966).

21. Edward S. Shaw, Financial Deepening in Economic Development, New York: Oxford University Press, 1973, and Ronald I. McKinnon, Money and Capital in Economic Development, Washington, D.C.: The Brookings Institution, 1973.

22. Both McKinnon and particularly Shaw have discussed several of the services of the financial system. A good summary, closely followed here, is Millard Long, "Review of Financial Sector Work," The World Bank, October 1983.

23. Surplus units are those with sufficiently abundant resources of their own, in comparison to their own internal productive and investment opportunities, so they earn low marginal rates of return on their assets, as compared to deficit units, which possess few resources, relative to their available opportunities, and could, if they had access to additional resources, earn comparatively high marginal rates of return. See Claudio Gonzalez-Vega, "Interest-Rate Restrictions and the Socially Optimum Allocation of Credit," Savings and

Development 4, No. 1:5-28 (January, 1980) for a proof that financial intermediation not only improves efficiency but also income distribution.

24. Research within the Agricultural Finance Program at the Ohio State University has provided several observations of transactions costs in the rural financial markets of LDCs. See Carlos E. Cuevas and Douglas H. Graham, "Interest Rate Policies and Borrowing Costs in Rural Financial Markets," July, 1982.

25. The importance of financial-market integration for a reduction of the dispersion of the marginal rates of return in the economy has been stressed by Ronald I. McKinnon, "Financial Policies," in J. Cody, H. Hughes, and D. Wall. eds., Policies for Industrial Progress in Developing Countries, New York: Oxford University Press, 1980.

26. Claudio Gonzalez-Vega, "Los Mercados Financieros Rurales en la Republica Dominicana. Un Marco Teorico de Referencia para su Investigacion," Ohio State University, Agricultural Finance Program, November, 1983.

27. Robert C. Vogel, "The Dynamics of Inflation in Latin America, 1950-1969," American Economic Review, (March, 1974).

28. See Jacob Frenkel and Harry G. Johnson, eds., The Monetary Approach to the Balance of Payments, London: Allen and Unwin, 1976. Also, Michael Connolly, "Optimum Currency Pegs for Latin American Countries," Journal of Money, Credit, and Banking 15, No. 1:56-72 (February, 1983) and H. Robert Heller, "Determinants of Exchange Rate Practices," Journal of Money, Credit, and Banking 10, No.3: 308-321 (August, 1978).

29. D. Sykes Wilford and Walton T. Wilford, "On the Monetary Approach to the Balance of Payments: the Small, Open Economy," Journal of Finance 33, No. 1:319-323 (March, 1978).

30. Robert C. Vogel and Francisco J. Chaves, "The Velocity of Money in Central America: Some Comments and Extentions," The Bangladesh Development Studies,

31. Computed on the basis of data in the Statistical Appendix. These rates of growth were 5.4 percent (Guatemala), 5.7 percent (El Salvador), 10.3 percent (Honduras), 9.1 percent (Nicaragua), and 12.0 percent (Costa Rica).

32. Computed on the basis of data in the Statistical Appendix. These rates of growth were 8.8 percent (Guatemala), 7.9 percent (El Salvador), 17.3 percent (Honduras), 16.1 percent (Nicaragua), and 10.7 percent Costa Rica).

33. For 1977, the M_2/GDP ratios were 32.9 percent (Costa Rica), 30.4 percent (Honduras), 29.6 percent (El Salvador), 28.5 percent (Nicaragua), and 23.9 percent Guatemala. These ratios compared to 9.9 percent (Chile), 14.3 percent (Brazil), 19.9 percent (Bolivia), on the one hand, and 65.5 percent (Singapore) and 69.9 percent (Taiwan), on the other hand. (All ratios computed with data from the International Monetary Fund, International Financial Statistics, January 1979.

34. For an analysis of the dynamics of currency substitution, see Arnoldo R. Camacho and Claudio Gonzalez-Vega, "Foreign Exchange Speculation, Currency Substitution, and Domestic Resource Mobilization: the Case of Costa Rica," paper presented at the conference on Financial Crisis, Foreign Assistance, and Domestic Resource Mobilization in the Caribbean Basin, Columbus, Ohio, May 1, 1984.

35. Luis Rene Caceres and Hector R. Gonzalez, "Una Investigacion sobre los Determinantes del Ahorro en Centro America," Comercio Exterior 31, No.1:51-56 (January, 1981).

36. Claudio Gonzalez-Vega, "Las Instituciones Financieras de Desarrollo y la Movilizacion de Recursos Internos en los Paises de America Latina," en James A. Hanson, ed., La Captacion y Movilizacion de Recursos por las Instituciones Financieras de Desarrollo, Washington, D.C.: Interamerican Development Bank, 1975.

37. Claudio Gonzalez-Vega, "Cheap Agricultural Credit: Redistribution in Reverse," in Dale W Adams, Douglas H. Graham, and J.D. Von Pischke, eds., Undermining Rural Development with Cheap Credit, Boulder, Colorado: Westview Press, 1984.

38. Carlos E. Cuevas and Douglas H. Graham, "Loan Targeting and Financial Intermediation Costs in Honduras," paper presented at the Allied Social Sciences Association Meetings, San Francisco, California, December, 1983.

39. The fiscal roots of financial repression have been particularly stressed by Ronald I. McKinnon, "The Order of Economic Liberalization: Lessons from Chile and Argentina," January, 1982.

40. As in other LDCs, open markets for primary securities are insignificant in Central America. This does not constitute a distortion; it merely reflects the low level of per capita income, high transactions costs, and the small size of markets.

41. For a detailed description of the collapse of the fixed-exchange rate regime in Costa Rica, see Arnoldo R. Camacho and Claudio Gonzalez-Vega, op. cit.

42. For the sake of uniformity, the size of the banking system was computed on the basis of financial magnitudes published by the Consejo Monetario Centroamericano, Boletin Estadistico, several years. To obtain real values, these magnitudes were deflated by the consumer price index published by the International Monetary Fund, International Financial Statistics, several years. To the extent that these consumer price indexes did not measure correctly the rate of inflation relevant for portfolio decisions, the figures reported probably understimate the degree of contraction of the financial system. No acceptable price indexes are available for Nicaragua, which is excluded from the analysis for this reason.

43. For a more detailed analysis of the impact of the crisis on the performance of the Honduran banking system, see Claudio Gonzalez-Vega, "Estabilidad Macroeconomica y el Sistema Financiero: el Caso de Honduras," Revista de la Integracion y el Desarrollo de Centroamerica, forthcoming, 1984.

44. See Claudio Gonzalez-Vega, "La Economia Costarricense en 1983: Logros, Peligros, Problemas Cronicos y Oportunidades," unpublished, Academia de Centro America, March, 1984, for a detailed description.

45. See Mario I. Blejer and Mohsin S. Khan, "Public Investment and Crowding Out in the Caribbean Basin Countries," for a discussion of both financial and real "crowding out." Paper presented at the Conference on the Economic Problems of the Caribbean Basin, Santo Domingo, Dominican Republic, December, 1983.

46. See, for example, Douglas H. Graham, Claudio Gonzalez-Vega, et. al., An Evaluation of Rural Financial Markets in Honduras, The Ohio State University: Agricultural Finance Program, December, 1981.

47. See Arturo Martinez-Moya, "The IMF Stabilization Program and Financial Reform: the Case of the Dominican Republic," paper presented at the Conference on Financial Crisis, Foreign Assistance, and Domestic Resource Mobilization in the Caribbean Basin, Columbus, Ohio, May 1, 1984.

48. On the problems of dollarization, see Guillermo Ortiz, "Currency Substitution in Mexico," Journal of Money, Credit, and Banking 15, No.2:174-185 (May, 1983).

49. Elsewhere I developed the concept of the "iron law of interest-rate restrictions," to explain the impact of financial regulations on the relative degree of access of different borrower classes to credit portfolios. In general, this concept may be used to predict the impact of increasing financial repression on the composition of the portfolio of loans of financial intermediaries subject to specific regulatory constraints. As a result of the crisis, preferred borrowers in Central America have benefited from increasing shares in loan portfolios, while rationed, non-preferred borrowers have received smaller loans, in real terms, and have had access to smaller shares in credit flows, or have been completely excluded from access to formal credit. Claudio Gonzalez-Vega, "Credit Rationing Behavior of Agricultural Lenders: The Iron Law of Interest Rate Restrictions," in Dale W Adams, Douglas H. Graham, and J.D. Von Pischke, eds., Undermining Rural Development with Cheap Credit, cit.

50. Arnoldo R. Camacho and Claudio Gonzalez-Vega, "Bank Competition, Deposit Mobilization, and Financial Concentration in Honduras," The Ohio State University: Agricultural Finance Program, January, 1984.

51. Interest rates became negative in real terms, for the first time, around 1974, as a consequence of the monetary expansion at the time of the first oil crisis. Although inflation rates were higher in the second half of the 1970s, Central Banks raised nominal rates sufficiently to keep them positive in real terms, until the last years of the decade. Recently, rates have been negative in all the countries of the region.

52. See Mario I. Blejer, "Exchange Restrictions and the Monetary Approach to the Exchange Rate," in Jacob A. Frenkel and Harry G. Johnson, eds., The Economics of Exchange Rates, Reading: Addison-Wesley, 1978.

53. See William R. Cline and Enrique Delgado, eds., Economic Integration in Central America, Washington, D.C.: The Brookings Institution, 1978; E. Torres Rivas, G. Rosenthal et al, Centro America Hoy, Mexico: Siglo XXI, 1975, and Eduardo Lizano, Escritos sobre Integracion Economica, San Jose: Editorial Costa Rica, 1982.

54. See Ian M. D. Little, Economic Development. Theory, Policy, and International Relations, New York: Basic Books, 1982.

55. United Nations Economic Commission for Latin America, Development Problems in Latin America, Austin: University of Texas Press.

56. At that time, development was overwhelmingly thought of in real terms. The role and malfunctioning of financial markets were not well understood. Commercial banks were attacked for their developmental inadequacy: they did not give long-term loans and neglected small producers, specially farmers. New institutions, such as development banks and cooperatives were called for. Because of the lack of understanding of the operations of financial markets, the newly created institutions were doomed to failure. See Douglas H. Graham and Compton Bourne, "Problems with Specialized Agricultural Lenders," in Dale W Adams, Douglas H. Graham, and J. D. Von Pischke, eds., Undermining Rural Development with Cheap Credit, cit.

57. Miguel Angel Rodriguez has made this clear in "Analisis del Informe Kissinger. Los Aspectos Economicos," La Nacion Internacional, March 1, 1984.

58. Carlos Diaz-Alejandro, who was a member of the Commission, has emphasized external over domestic factors elsewhere. "The occasional domestic earthquake, crop failure, or indigenous madman in authority paled into insignificance compared with the external shocks," in "Stories of the 1930s for the 1980s," in Pedro Aspe Armella, Rudiger Dornbusch and Maurice Obstfeld, eds., Financial Policies and the World Capital Market: The Problem of Latin American Countries, Chicago, The University of Chicago Press, 1983.

59. Report of the National Bipartisan Commission on Central America, cit., pp. 44 and 50.

60. See J. Malcolm Dowling and Ulrich Hiemenz, "Aid, Savings and Growth in the Asian Region," Asian Development Bank, April, 1982.

61. Melvyn B. Krauss, Development Without Aid. Growth, Poverty and Government, New York: McGraw-Hill, 1983.

62. J.D. Von Pischke and Dale W Adams, "Fungibility and the Design and Evaluation of Agricultural Credit Projects," American Journal of Agricultural Economics 62, No. 4:719-726 (November 1980).

63. For a discussion of the problems associated with foreign aid and resource allocation see Dale W Adams, "Foreign Assistance, Economic Policies, and Agriculture in Central America," paper presented at the conference on Financial Crisis, Foreign Assistance, and Domestic Resource Mobilization in the Caribbean Basin, Columbus, Ohio, April 30, 1984.

64. Manuel F. Ayau, "Lending Institutions Stall Latin American Progress," The Wall Street Journal, November 18, 1983.